



**Entrepreneur
& Family**
BUSINESS COUNCIL

Legal Compliance and Risk Management:

Does Your Business Have Good CARMA?





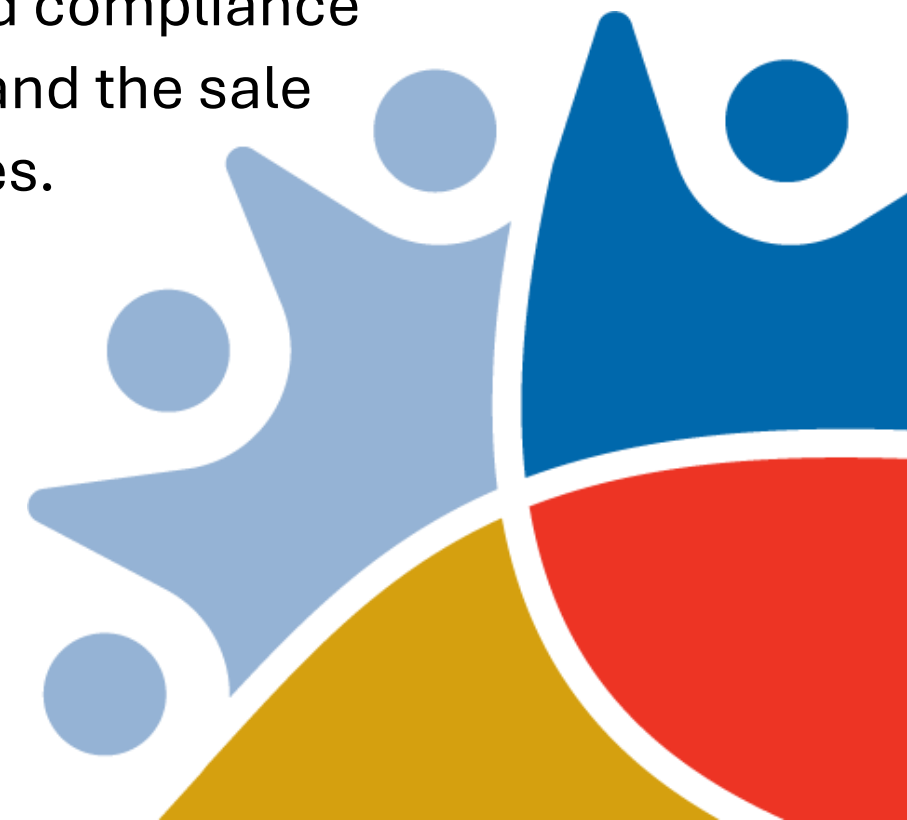
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Eric VanderPloeg is an attorney and shareholder with the law firm and EFBC Strategic Partner, Burke, Warren, MacKay & Serritella, P.C., a mid-size business law firm with a focus on Chicago area businesses and business owners. Mr. VanderPloeg is a business litigator, who also serves as general counsel to clients in a variety of industries, including manufacturing and distribution, automotive, and real estate. Mr. VanderPloeg regularly counsels clients on risk management and compliance matters, as well as courtroom disputes, and the sale and acquisition of closely held businesses.



1 in 4 Business Disputes Exceed

\$200,000

In legal fees

(2022 ACC Survey)

\$160B - 48%

**Share of U.S. Business Liability
Borne by Small Businesses
2023 U.S. Chamber of Commerce**

\$2,019,248

**Mean Outside Legal Cost of a “Major Case”
(2010 Conference on Civil Litigation – Duke Law School)**



Does Your Company have Good CARMA?

- Compliance and Risk Management as an Asset (CARMA)
- Businesses with good CARMA tend to be **more valuable**
- **Direct Costs:**
 - Liabilities and litigation costs are a direct expense to the bottom line
 - Litigation/Non-Compliance is a breach of many loan and other covenants
- **Indirect Costs:**
 - Sale of Business and Financing Transactions – Diligence Requests
 - Exposure = Loss of Productivity, Morale, Reputation
- **Today's Goal:** To put management in a better position to identify areas of exposure and begin to develop better risk management strategies

Four Laws of Building Good CARMA

Law #1

Manage internal Affairs and Corporate Governance

Law #2

Mitigate third party risk (TPRM)

Law #3

Protect your companies' assets

Law #4

Prioritize regulatory compliance

CARMA Law # 1:

Internal Affairs and Corporate Governance

- Managing Risk from within the Organization
- Shareholders and Other Equity Holders
- Directors and Officers
- Employees



What's a Fiduciary and How Did I Become One?

- **Default Rule:** Nearly all management level directors, officers and employees owe fiduciary duties to the company and/or the equity holders
 - **Test:** Supervisory responsibility/position of trust and control
- One of the most common claims brought against directors and officers in business litigation
- **Closely Held Companies:** Fiduciary duties may run between equity holders
- **Derivative Lawsuits:** A lawsuit brought on behalf of the company by an equity holder
- **Business Divorces:** Break up of equity holders through litigation



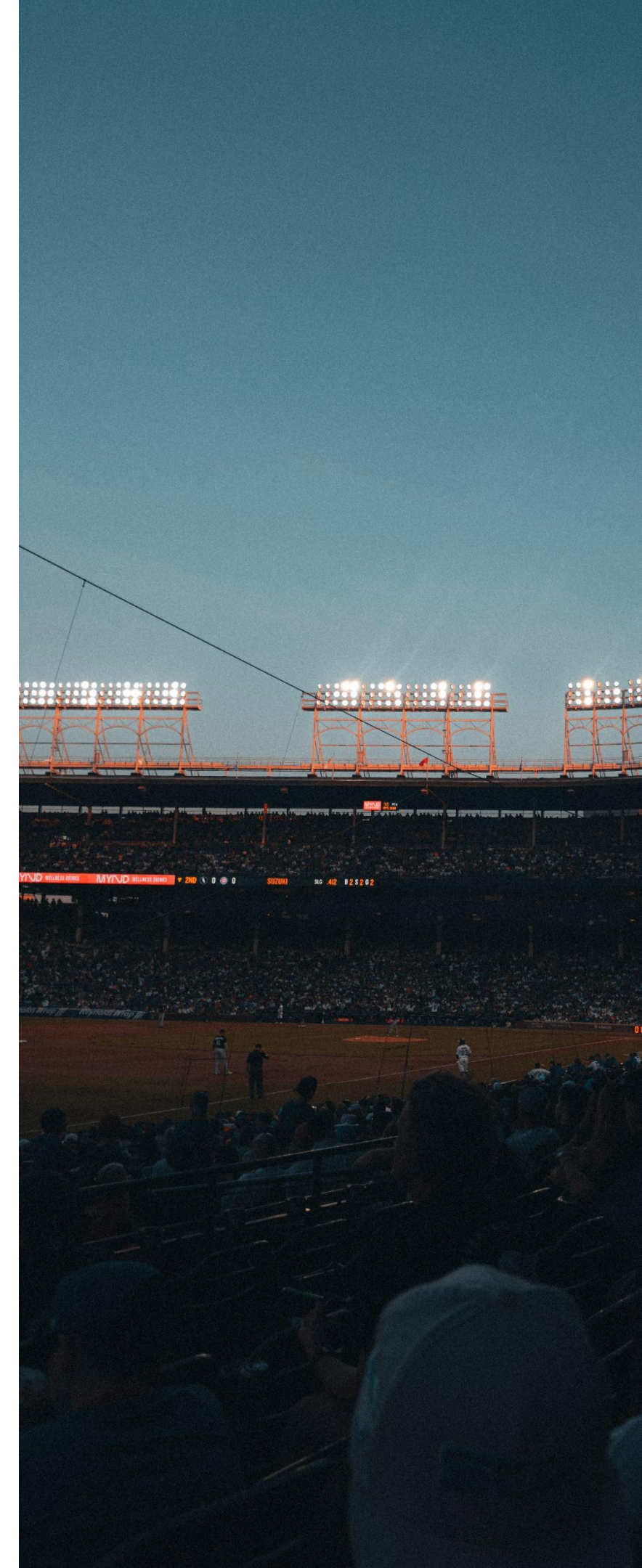
The Common Fiduciary Duties:

- **Duty of Loyalty**
- **Duty of Care**
- **Duty of Confidentiality and Disclosure**
- **Good Faith and Fair Dealing***

Loyalty	Care	Confidentiality / Disclosure	Good Faith / Fair Dealing
EXAMPLE	EXAMPLE	EXAMPLE	EXAMPLE
<ul style="list-style-type: none"> • GP of Company X makes \$5m loan to personal affiliate at 1% interest. Going rate is 4.5%. • President and controlling owner agrees to 50% discount for customer in which he has a 40% stake. • CIO declines investment opportunity for company, later forms NewCo to invest in same opportunity. 	<ul style="list-style-type: none"> • Board of XCO authorizes acquisition of YCO, despite warnings from counsel and accountants about irregularities in YCO's invoicing. YCO is later sued and costs XCO millions. • President cancels product line of company, believing advice of YouTuber that there is no future in the product. Competitor later makes millions selling the product. 	<ul style="list-style-type: none"> • Board member leaks upcoming sale of company while teeing off on Hole 3. Word gets out to employees, and buyer pulls out of deal. • CFO recommends acquisition of XCO to Board, and believes it to be a great deal. Doesn't tell Board about concerning fourth quarter loss, which he believes is an anomaly. XCO fails. 	<ul style="list-style-type: none"> • President and majority owner refuses to distribute profits from XCO, which is over capitalized, in order to coerce minority owner to sell interest. • Board spins off division to a subsidiary entity, knowing that VP of Sales comp is tied to profits from division. Tells VP of Sales that profits are no longer part of comp.

The “Business Judgment” Rule:

- The law provides corporate fiduciaries some protection for exercising corporate discretion and decision making when made in good faith and reasonable care, even when financial loss results.
- Disinterested management decisions are generally entitled to a presumption of good faith.
- **Shlensky v Wrigley**, 237 NE 2d 776 (Ill. App. 1968) (Wrigley lights)
- An Objective Standard: Commercial Reasonable Judgment
- Most common mistake: Conflicts of interest



Common Internal Disputes



Distributions of Profits

Claims by minority partners that companies are failing to distribute capital/excess profits are very common.

Board/management typically must have a compelling business reason for not distributing excess profits.

Access to Books and Records

State laws, and many corporate agreements, authorize equity holders to gain access to internal and sensitive company records. State laws may even impose penalties for non-compliance. Common disputes involve the purpose of the request, the scope of the request, and whether the request is properly made.

Sale of Business/Valuation

Many state laws require “supermajority” vote or even unanimous vote to sell all or part of a business, not simply majority vote. Even when the votes are sufficient, management has a duty of loyalty and care to maximize value and make sure that valuations are well supported.



Limiting Fiduciary Duties and Avoiding Claims

By Contract

Most state laws allow companies to limit or even eliminate most fiduciary duties through contracts, such as shareholder agreements or operating agreements, or provisions in articles of incorporation.

By Abstention

It is nearly impossible to bring a claim for breach of a fiduciary duty of loyalty against an interested party when disinterested approval was obtained. Even when action may be authorized, it is prudent to obtain disinterested vote.

By Diligence and Formality

Internal disputes are much less common, and claims harder to bring, against companies that maintain corporate formalities, obtain annual ratification, maintain separate accounts, and keep good books and records.

Buy Insurance!

Director and Officer (“D&O”) and other types of insurance can provide companies with coverage for fiduciary and other claims brought against management, who may be entitled to indemnification or “advancement.”

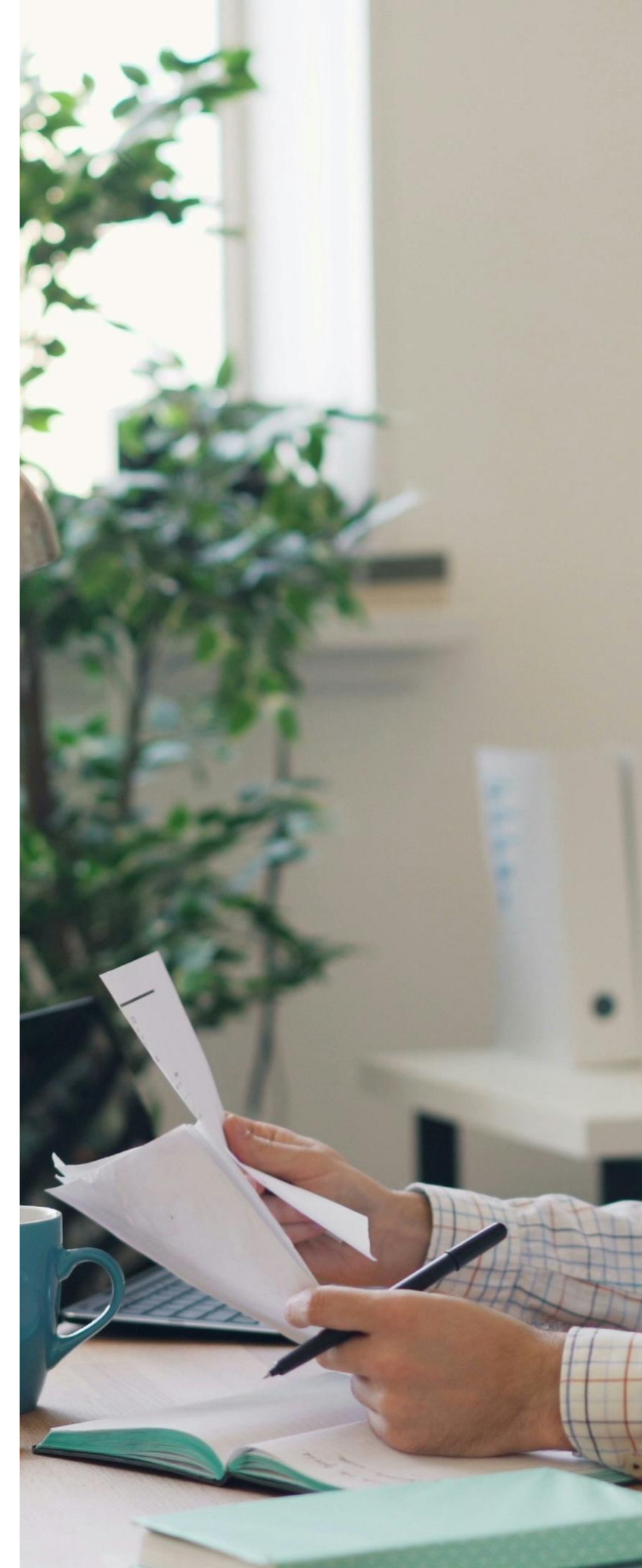
CARMA Law # 2:

External Affairs and Third-Party Risk Management

- Even if your house is in order, it is equally important to build the moat to protect your company from exposure to third-parties.
- Primary business disputes with third-parties involve breach of contract and commercial tort claims (fraud, tortious interference).
- TPRM is a “buzzword” with many meanings. Here, it primarily means contract review and due diligence on third-party vendors, customers and suppliers.
- Focus on contract negotiation and implementing clear, careful policies for employees who engage with third parties.

The “Statute of Frauds”

- **Common misperception:** unsigned or oral contracts are not enforceable
- **Only certain contracts have to be in writing and signed:**
 - Contracts for sales of goods more than \$500
 - Contracts for sale of real estate
 - Contracts for a term of more than one year
 - Contracts to guarantee a debt
- Almost all “agreements” are enforceable if one party has fully performed or both parties have started to perform
- Sales Agreements: Can be formed through purchase orders and invoices, even if unsigned



Customer and Vendor Diligence and Negotiation:

- Clients often assume that form contracts used by customers or vendors are non-negotiable - often untrue.
- **Even minor contract review and negotiation can secure important concessions:**
 - Mutuality and Certainty of Obligations
 - Payment terms / Security & Deposits
 - Data Security and Privacy
 - Indemnification / Defense
 - Force Majeure
 - Limitation of Liability / Disclaimer of Warranties
 - Dispute resolution / Venue
- Companies should establish and follow procedures for performing diligence on new customers and vendors.



Limitation of Liability and Disclaimer of Warranties:

- Contracts can be used to disclaim liability for certain conduct in one or more ways:
 - Exclude certain types of damages, such as “**consequential damages**”
 - Cap damages to payments made under the contract
 - Limit the time period for asserting contract claims
 - Set a favorable “**venue**” and “**jurisdiction**” for disputes
- Disclaim all non-express warranties and extra-contractual representations:
 - All “**implied warranties**” should be disclaimed to the fullest extent of the law, must comply with state law requirements
 - Some service industries also have implied warranties
 - Representations should be limited to those in the agreement

Establish Protocols for Communicating with Third-Parties:

- Statements to third-parties by unauthorized or untrained employees are a key source of B2B or B2C litigation
- **“Apparent Authority:”** A representative who makes a promise to a third-party, who reasonably believes the representative is authorized to make the promise, can bind the company if it has been relied upon.
- Establish guidelines and training for employees on scope and limitations of their authority to bind the company
- **Best Practice:** Limit the representatives who communicate with third-parties
- **Avoid Admissions:** Don't be so quick to apologize when a dispute is on the horizon

Alternative Dispute Resolution:



“Arbitration”:

A private and confidential form of litigation, which goes to a binding decision of a private arbitrator, usually an experienced lawyer or former judge.

“Mediation”:

A confidential settlement procedure (usually non-binding, unless an agreement is reached) involving an experienced neutral who helps the parties weight the pros and cons of litigating the dispute and tries to reach a settlement.

Alternative Dispute Resolution:

Cons

- Few methods to “get rid” of a case at an early stage.
- Involves payment of fees to the arbitrator and a private tribunal
- Discovery can be just as comprehensive as in court.
- No appeal or ability to challenge decision.
- Not necessarily less expensive than litigation in court.

Pros

- Confidential
- A deterrent in some contexts (consumer, employment)
- Avoid class actions (although, class waivers are still necessary)
- Usually faster than court litigation.
- Some flexibility and potential cost savings.

Takeaway: Arbitration clauses should be used and agreed to selectively and strategically, and narrowly tailored to address expected needs in arbitration.

Combining Mediation and Arbitration: More frequently, agreements call for non-binding mediation as a condition of proceeding to

CARMA Law #3: Asset Protection

- Protect IP, Data, and Trade Secrets
- Use Liens and Security Agreements
- Maintain Limited Liability
- Avoid “Fraudulent” Transfers



Intellectual Property and Proprietary Data



- **Hard IP and Registrations:**
 - Patent Protection – Considerations for Manufacturers
 - Trademark Registration – Trade names, logos, slogans
 - Copyright - Creative works
- **Soft IP:**
 - Trade Secrets and Proprietary Data
 - Typically protected by state and federal statute
 - Often requires confidentiality agreements and steps to protect information
 - Business models are generally not protectable
 - Utilize state appropriate restrictive covenants
- Assignments of IP Rights – Employees and Consultants

Protect it or lose it:

There is little protection for publicly available information

Liens and Security Agreements

- Liens typically are created by statute – some common law exceptions
- **Security Agreements:** A contract that creates a security interest in certain property
 - Must be “perfected” to be enforceable against others
 - Key consideration for seller of goods on credit
 - Must be mindful of existing liens and security interests of other creditors



Limited Liability Entities and Maintaining Protections

- Under state law, equity holders in most entities are protected from claims of the company's creditors, including third parties
- Use of layers of limited liability companies is ideal for some situations, but comes with taxation and other legal considerations
- **Maintaining the “corporate veil”**
 - Creditors can try to “pierce the corporate veil” in lawsuits
 - Thinly capitalized
 - Disregard of corporate formalities
 - Failure to maintain separate accounts and books



Fraudulent Transfers and Successor Liabilities

- Transfer of assets from one entity to another after a creditor claim arises can be a violation of state statutes and lead to “avoidance” of the transfers
- Claims can expose third parties or family members to liability, if not careful
- State laws typically prohibit entities from distributing funds to equity holders when creditor claims exist
- Successor entities may face liability for certain debts or claims of the processor entity
- Can expose acquiring company to liabilities, even if excluded under asset purchase agreement
- Planning is key to successful asset protection – once its too late, its too late

CARMA Law # 4: Manage Compliance

- Businesses must meet a dizzying array of federal and state laws, regulations, local ordinances, trade rules and standards.
- Lawyers are not necessarily the best resource for all compliance needs – utilize in-house personnel and industry-specific compliance vendors.
- Compliance presents huge upfront costs to businesses, but compliance risk also presents some of the largest liability to small businesses.



Common Areas of Compliance:

- Environmental (EPA)
- Wage and Hour (FLSA, FLMA, IWPCA)
- Employee Benefits (ERISA)
- Tax/Audit (IRC, SOX, GAAP)
- Accessibility (ADA)
- Privacy, Data and Security (GLBA, FTC, BIPA)
- Workplace Safety (OSHA, DOL)
- Consumer Protection (FTCA, CFDPA, FCRA, FDCPA, TILA, Dodd-Frank)
- Financial Reporting (SOX, GAAP)
- Discrimination/EEO (Title VII, ADA, Title IX)
- Corporate Governance (CTA, State Statutes)
- Product Safety (CPSA, FTCA)
- Communication (FTCA, FTC)
- Marketing (FTCA, ICFDPA, TCPA)
- Anti-Corruption/Money Laundering (FCPA, CTA)
- Labor (NRLA, FLSA, IRCA)

Best Practices for Prioritizing Compliance:



- Appoint a Chief Compliance Officer
- List your company's compliance needs and inventory your current compliance practices.
- Hire and consult with vendors to assist with specific compliance needs (e.g., Benefits, OSHA, Data Security, Tax)
- Utilize resources from industry associations or regulators
- Emphasize and incentivize compliance education
- Document your compliance plans and efforts and evaluate your progress

Privacy and Data Security



- **Number 1** compliance need for the digital age
- Implement Role Based Access Control (RBAC)
- Monitor and utilize agreements with third-parties to protect data and cover risk (Data Sharing Agreements, Data Processing Agreements)

Be mindful of state legislation:

- BIPA: Must obtain written consent and maintain record keeping protocols
- Personal Information and Protection Act, 815 ILC 530/1 et seq
- **Watch:** Illinois Privacy Rights Act – Proposed Legislation

Securities and Tax:

- Securities regulation is not typically a concern for small businesses, but an exemption must still apply and be utilized
- Most CPAs will address most state and federal compliance issues, but must rely on accurate and properly kept business records
- **S-Corp Status:**
 - Subchapter S status requires a single class of equity with respect to the distribution of profits.
 - Jeopardized through compensation agreements with equity holders
- Use/Sales Tax Reporting: Problems for remote sellers; **“economic nexus”**



Other Compliance Considerations:

- **CTA/BOI:** 2025 rules now only require reporting for foreign corporation
- **Record Keeping:** Seven years still the rule of thumb for many records, but when in doubt, ask
- **Document Retention/Destruction Policies:** Must be mindful of pausing automatic document destruction policies in the event of a potential dispute, includes email and data storage systems
- **OSHA:** Can obtain a free, confidential onsite consultation from OSHA
- **Be wary of IP and ADA “trolls”** – Professional plaintiffs looking for alleged IP and ADA compliance violations on websites and public business areas.

Takeaways

- **Business Case:** Companies with Good CARMA have more value in the short and long term
- Assigning responsibility and staying educated are keys to maintaining Good CARMA
- Carefully inventory internal and external agreements, and take note of deficiencies
- Consult with advisors, vendors, and legal team

Presenter Contact Info



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